

IN Your INTEREST FINANCIAL PLANNING



2008
Autumn Newsletter

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of rain. Well it has hardly stopped raining since then, giving us the wettest year for many years – so now it is sunshine that feels like great weather.

In this newsletter we address the hot topic, “Borrowing to Invest”. The vast majority of people are actually borrowing to invest without realising it.

What is the difference between a person going broke, another doing ok and a third doing extremely well – all in the same circumstances and with the same income?

The difference is primarily in their head and their actions flow from what is happening inside their

head. We discuss the psychological side of financial advice, which is far more important to your wealth than you might imagine.

The last months have been very volatile and of course do have an effect on most people's head! Please contact us to discuss any questions, thoughts or concerns you may have.

Kind Regards,
Christoph Schnelle

Hello FROM CHRISTOPH

Welcome to our Autumn 2008 newsletter. In our summer newsletter we said we had great weather – lots

INSIDE YOUR HEAD

The biggest damage to your finances happens inside your head. First you (unconsciously) decide to neglect yourself or to spend excessively and then you find a reason. Most of those reasons don't stand up to scrutiny, just like the one in the cartoon on the next page.

The work of a financial adviser is to reverse this process: Listen to the reasons and find the unconscious decision that is behind the given reason (I am too young, I am too old, I am too busy, it won't work anyway) and to make that decision conscious.

This gives the client a choice to continue their behaviour or to start modifying their behaviour. Some people easily and quickly change, for others it will take a few more years of continuing their behaviour. However, the latter now have the choice, know what they are doing and know what to change.

The above is the psychological side of financial planning which comes on top of optimising your existing financial situation where you don't need to change your behaviour at all. Optimising your existing financial situation is like free money for

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- Inside your head
- Should I borrow to invest?
- The margin lending mess
- Investment snippets

doing very little. Changing your behaviour makes your life easier and more fun once you are ready, on top of the free money.



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SHOULD I BORROW TO INVEST?

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Whether you should borrow to invest or not is almost entirely tax driven, provided you borrow the right way – don't go to the likes of Opes Prime (see next article).

Remember, you are borrowing to invest when you have a mortgage and investments, or when you put extra money into super whilst still having a mortgage, or even when you have an investment property with a mortgage. You are of course also borrowing to invest if you buy shares with a margin loan.

If there are no tax advantages then borrowing to invest is usually a mug's game. There are much bigger up and down swings and over the last 100 years you would have often ended up much worse off than if you hadn't borrowed. In many cases it wouldn't have made much of a difference, just created a much wilder ride.

However, the situation is completely different if you have a good income, i.e. if you are in the 30% or higher tax bracket. The more you earn, the bigger risks you can take because, if things go wrong, the taxman shares your pain and thereby dramatically reduces your risk.

If you have a good income, then buying property with the help of a mortgage or putting money into super instead of paying off your mortgage, especially if you are over 45, can be very good ideas.

If you are in the 40% or higher tax bracket, even buying shares on margin can become worthwhile. Why? The higher the tax bracket you are in, the more support you get from the government in the form of reduced taxes, especially when the sharemarket goes down. However,



buying shares on margin can be very dangerous and can be excruciatingly painful or very rewarding, you just won't know which.

It can be excruciatingly painful because there is a basic difference between margin loans and mortgages: You very rarely lose your house if your mortgage repayments are up to date, even if your mortgage is more than the value of the house. With margin loans, your lender can dramatically change their lending conditions at any time and during periods of great volatility you can lose your entire investment. See the next article about margin lending for more details.

Also people tend to go into margin lending at the wrong moment. If the sharemarket had a great run as it had in July 2007, everyone starts talking about margin loans and lots of people take them up. That's the worst time to do it, though. Often, the best time to buy shares on margin is when everything is doom and gloom and few people have the ability to say 'shares are cheap, let us buy shares...'. To be greedy when others are fearful, to paraphrase Warren Buffett, is very difficult to do.

Investment snippets from Jim Parker's book – outside the flags

Quote from Warren Buffet – regarded as one of the world's greatest stock market investors:

“We are not good at predicting the markets and we spend little or no time thinking about it”

Insights from a series of interviews with a group of legendary investment managers:

“Exercise discipline, remember that risk and reward are related, focus on asset allocation, remain diversified, and stay aware of costs and taxes.

“Evolution gone Wrong: How and Why Monkeys are Outperforming Active Managers” written by Professor Huber of the Yale School of Management

This academic paper shows evidence that monkeys, school-children and blindfolded dart throwers have more success in picking stocks than market professionals.

Bloomberg Markets Magazine in October 2006 carried the results

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WHAT IS THE MARGIN LENDING MESS ALL ABOUT?

You may have heard about Opes Prime, Lift Capital and ANZ bank in the news recently and wondered what it was all about. In a nutshell, it is about margin lending with sometimes shady practices.

Margin lending without shady practices works like this: If you had invested in Australian shares until November 2007, you would have made around 20% a year for four years. In other words, \$1,000 would have become \$2,000. These are great returns. However, many geared funds (funds that borrow) made 40% a year for those four years and \$1,000 would have become \$3,800. Many people looked enviously at the 'lost' \$1,800 (\$3,800 - \$2,000) which they didn't make.

So, last July everybody and their dog advertised margin lending where you put up \$1,000 and the bank would put up \$1,000, \$2,000 or even \$4,000. You paid 9-11% interest but, since shares go up by 20% a year, you would make a lot of money. Well, instead, shares fell by 20% and the investor bore the entire cost of the fall plus interest. If the investor borrowed \$2,000 he/she would have lost \$600 and \$200 interest and the initial \$1,000 became just \$200 while the investor still owed the \$2,000 borrowed.

The banks then looked at the investor's account and said that there is not enough buffer for further falls. The banks then initiated a margin call and said "Either you put in more money or the bank will sell your shares".



Opes Prime and some others added a big twist to margin lending that led to their downfall:

They behaved like a bank to all their customers and gave margin loans. Then they pooled all their investors' money and shares and went to ANZ and others and asked them for a margin loan on everything. They could do this because Opes Prime and others had special contracts with their clients - which many clients didn't understand - that allowed this.

This big margin loan that Opes Prime received from ANZ was then abused. Opes Prime gave some of its clients special treatment - these clients could borrow more and more shares without putting in any extra money. The money came from the other customers who didn't know what was happening. How? Not many customers buy the maximum possible number of shares that they can. Therefore many customers had more money in their Opes Prime account than they needed to. This extra money was then used by some favoured clients to buy more and more shares until it all blew up because Opes Prime defaulted on their loan, the banks sold the shares in a hurry and the investors lost most of the money they had in their Opes Prime accounts.

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of a survey to determine the world's top stock pickers. They investigated 350 firms over a two year period to test the accuracy of their individual forecast on shares of the world's 200 largest companies by market value.

The most accurate global investment bank got a score of 34 per cent. That means that the BEST was wrong two thirds of the time.

One of the major banks had a stock picking score of 16 percent - that means it was wrong 84% of the time!

And the story was about "The World's Top Analysts" ie well resourced investment banks with highly paid analysts and access to every conceivable source of information.

Check out:

<http://www.inyourinterest.com.au/files/pdf/20080102Australian.pdf> where you can see a review of The Australian newspaper's top 100 tips for 2007. Amongst the many duds listed was Basis Capital, chosen as The Australian's top fixed interest pick for 2007. Not long after, Basis lost most of their investors' money even though fixed interest investments should be particularly safe. The above is not a reflection on the stock picking skills of The Australian - but the concept of stock picking at all. The press (which needs to generate news) is geared towards stock picking, timing, churn and all those things that lose you money!

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